



*A not-for-profit health and tax policy research organization*

Hearing before the  
HOUSE COMMITTEE ON THE BUDGET

## **The Tax Code and Health Insurance Coverage**

Chairman

The Honorable John M. Spratt, Jr.

Ranking Member

The Honorable Paul D. Ryan

October 18, 2007

Testimony by

Grace-Marie Turner

President, Galen Institute



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**President, Galen Institute**

Chairman Spratt, Ranking Member Ryan, and members of the committee, I sincerely thank you for calling this hearing today to address the crucial issue of the tax code and health insurance, and I particularly appreciate the opportunity to testify before you today.

I founded the Galen Institute 12 years ago primarily because I wanted to highlight this issue and promote an informed debate over what I believe is a central driving policy in our health sector. While the favored tax treatment of health insurance has provided a stable source of health coverage for hundreds of millions of American workers over the last half century or more, it also is clear that it is leading to many of the problems that our health sector faces today. This issue is well worth addressing today.

There are a number of provisions in the Internal Revenue Code that address health care. For example:

- That part of an employee's compensation package that he or she receives at work in the form of employer-sponsored health insurance is excluded from income and payroll taxes.
- Employers can deduct as a business expense the amount they pay for health insurance for their workers.
- Workers whose employers offer Section 125 cafeteria plans, called flexible spending accounts, can put aside a portion of their income on a pre-tax basis to pay for allowed expenses, including their share of health insurance premiums, copayments, and other allowed medical expenses. Any amount that is unspent at the end of the year reverts back to the employer.
- A 2002 IRS ruling interprets existing law to give companies the opportunity to make deposits to Health Reimbursement Arrangement spending accounts that are tax-free to their employees.
- The self-employed can deduct the cost of health insurance from their income.
- Individuals can deduct medical expenses on itemized returns if their expenses exceed 7.5% of their adjusted gross income.
- Individuals or workers who have high-deductible health insurance policies can put money aside in Health Savings Accounts on a tax-free basis to pay for medical

expenses today or in the future. The HSA deposit is tax free, the inside buildup or interest is tax free, the money stays tax free as long as it is spent on allowed health expenses, and the HSA money rolls over from year to year.

## **The Cost**

Economist John Sheils estimates that the favorable tax treatment of these health expenses was worth \$188.5 billion in federal tax savings to individuals and companies in 2004.<sup>1</sup> The amount of these tax benefits grows each year without a vote by Congress. Sheils estimates that when federal and state tax benefits are combined, the total in 2004 was \$209.9 billion.

This is a sizeable investment by any measure, and it seems appropriate to ask if we are getting our money's worth.

The biggest "tax expenditure," as Sheils describes it, and the one that I would like to address today, is the employee tax exclusion for job-based health insurance. Section 106 of the Internal Revenue Code gives employees a generous – yet invisible – tax preference for the health insurance that they receive through the workplace. I will argue that employers should continue to be allowed to deduct the cost of health insurance as a legitimate business expense, but that employees should *not* continue to receive tax exemption for an unlimited amount of health insurance because of the distorting effects this exclusion creates throughout the health sector. Further, I will argue that there are better ways to use the tax code to support health insurance that are more appropriate to a 21<sup>st</sup> century economy.

## **The Tax Exclusion: History and impact**

It is worth noting that the tax exclusion for employment-based health insurance is the single largest tax break allowed by federal law, worth more than \$160 billion.<sup>2</sup> (By comparison, the popular home mortgage interest deduction is worth \$88 billion to American taxpayers.) The tax exclusion for health insurance provides a huge incentive for employees to receive their health coverage through the workplace. And because of our progressive income tax system, the benefits are heavily skewed toward higher-income workers. According to Sheils, the average employee earning \$100,000 a year or more shields \$2,780 a year from taxes by getting health insurance through the workplace. But an employee earning \$10,000 to \$19,999 gets only \$292 in value from this tax provision, nearly a 10-fold difference.

It is not surprising that the majority of the uninsured are workers and their dependents in these lower-income categories. The deck is stacked against them: They are less likely to have jobs that provide health insurance, less likely to be able to afford their share of the

premiums if their employers do offer insurance, and less likely to get much value from the tax exclusion since they are in lower tax brackets.

I don't believe we would ever intentionally have created a system that would have this result. Rather, it evolved from a simple decision decades ago.

## **THE HISTORY<sup>3</sup>**

Early in the 20th century, the link between health insurance and the workplace began to be established in the United States. During and after World War II, however, employment-based health insurance became more widespread, and the link became stronger.

Factories were pushed to meet wartime production schedules. Competition for good workers was intense but was hampered by wartime wage controls. Employers found they could compete for scarce workers and boost compensation without running afoul of these controls by offering health insurance as a benefit in lieu of cash wages. In 1943, federal officials ruled that employers' contributions to group health insurance would not violate wage controls and would not count as taxable income for employees.

That ruling, later codified by Congress in 1954, in addition to rising tax rates on middle-class incomes and the rising demand for health insurance, all combined to create a strong incentive for health insurance to be obtained through employment-based groups.

The generous tax preference accorded to job-based health insurance is a historical accident that has increased automatically over the decades without legislative authorization or appropriations. It has percolated through the economy for more than 60 years to become the foundation for a system that provides strong financial incentives for more than 177 million Americans to get their health insurance through their employers.<sup>4</sup>

## **HOW THE TAX PREFERENCE WORKS**

Employment-based health insurance is part of the compensation package many employers provide to their employees as a form of non-cash wage. Employers can take a tax deduction for the cost of this health coverage, as they do for most other forms of employee compensation. They write the check for the premiums, and some pay medical bills directly if they self-insure. Businesses deduct these costs from their earnings since they are part of the total compensation package paid to workers and must be deducted to measure net profits correctly.

What makes health insurance different from cash wage or salary compensation, however, is that workers also do not pay taxes on that part of their compensation package they

receive in the form of health benefits. That part of their pay is tax free.

Section 106 of the Internal Revenue Code provides that the value of health benefits is not counted as part of the taxable income of employees – i.e., it is excluded from their taxable income as long as the employer writes the check for the coverage. However, workers may receive this tax-favored benefit only if health coverage is provided through an employer. Because it is excluded from their taxable income, the value of the health coverage, the tax benefit, and the costs in forgone cash wages are largely invisible to workers.

## **HOW THIS DISTORTS THE HEALTH CARE MARKETPLACE**

The employee tax exclusion for job-based health insurance distorts the health care marketplace in a number of ways:

- It undermines cost consciousness by hiding the true cost of insurance and medical care from employees.
- Because the full cost of health insurance is not visible to employees, it artificially supports increased demand for covered medical services and more costly insurance. As a result, inefficient health care delivery often is subsidized at the expense of more efficient care and coverage.
- Cash wages are suppressed as health insurance costs rise.
- Many employees with job-based coverage have little choice and control over their health insurance and their access to medical services.
- The tax benefits are skewed to favor higher-income individuals and those who demand the most expensive health coverage and medical treatments.
- Those with equal incomes are taxed unequally.
- Millions of Americans who are unemployed or whose employers do not offer health insurance are discriminated against because they receive much less assistance, if any at all, when they purchase health insurance.

With four in ten workers changing jobs in the U.S. every year,<sup>5</sup> this provision which so generously subsidizes health insurance through the workplace is leaving millions of Americans behind. They lose their health insurance when they lose or change jobs, and many may work for employers who can't afford to offer coverage. These workers receive little or no benefit from this regressive, rich, and hidden tax preference for employment-based health insurance. It is no surprise that they are most likely to be uninsured.

But the provision causes problems even for those who do have job-based coverage. A key element of the problem relates to visibility. Deductions are visible, but exclusions are invisible. When straight tax deductions are taken, as employers do in deducting the cost of health insurance, the full cost of the expenditure is visible because they must first make the payment before taking the deduction. Because employers write the checks for health coverage, they *do* complain about the high costs of health care.

On the other hand, employees who are demanding expensive health insurance seldom know the full cost of the policy – and the amount of compensation they are forgoing as a result – because its cost is excluded from their income. Few employees are aware that an average of \$12,000 a year of their compensation package is going to fund their family health insurance policy.<sup>6</sup> Employees may be receiving smaller pay raises as a result of the rising cost of health insurance, but this is a less visible consequence. If employees saw health insurance as a more visible part of their pay package, they would likely make different choices than they do today about that spending.

### **So what should we do?**

Many members of Congress from both sides of the aisle have offered proposals that would move public policy forward regarding the tax treatment of health insurance. Rep. Ryan, for example, is working on a proposal that would provide a universal tax credit for health insurance. President Bush has offered a proposal to replace the current tax exclusion with a generous universal tax deduction. Others have offered proposals for income adjusted, refundable tax credits. And some are considering a combination of a tax deduction and credit. Senator Hillary Clinton in her recent health proposal recommends capping the amount of income that higher-income employees can exclude from taxes through health insurance.<sup>7</sup>

The most important thing here is that we are having a conversation about this important issue.

I facilitate a group called the Health Policy Consensus Group that is composed of the leading health policy experts from the market-oriented think tanks. We have long advocated addressing the tax treatment of health insurance, and many of our members support refundable tax credits for health insurance.<sup>8</sup>

President Bush's proposal earlier this year to allow a universal tax deduction brought a new idea to the table in allowing a generous deduction for health insurance combined with a credit against payroll taxes. Because all workers pay payroll taxes, this latter proposal would provide help to those at the lower end of the income scale who may not owe income taxes or are in a very low tax bracket.<sup>9</sup>



Whatever we do to address problems in our health sector, we know from experience that trying to make too many changes too fast will create a backlash of opposition. Even though the tax exclusion for job-based health insurance contributes to many of the distortions in our health sector, any changes will need to be gradual and give employees and employers options and time to adjust. But with so many people left out of the current system of tax subsidies for private insurance, it is crucial that we build a new system that does not tie health insurance so tightly to the workplace. Policy changes would allow us to move toward a system that allows health insurance to be portable from job-to-job, that allows people to make their own decisions about the health insurance that suits them and their families, and that makes the subsidies for health insurance fairer and more equitable.

### **The coming information revolution in health care**

For decades, our health sector has been organized around a paternalistic system in which government agencies or corporate human resources departments have been in charge of making decisions for people about their health benefits. This means that the vast majority of people have little experience or even confidence in making their own decisions involving health care and health insurance, and they have had little information that allows them to seek out the best value in their health spending.

This is beginning to change: New resources are being offered to help consumers learn which physicians and hospitals are more highly rated for certain procedures. The Internet is facilitating a wider dissemination of information about everything from the cost of health procedures, availability of new medical treatments and medicines, and the options for individually-purchased health insurance. Health Savings Accounts and other consumer-centered health care financing arrangements are giving people new incentives to search for options and to seek value in their health spending.

Demands from consumers for greater involvement in their health care decisions is taking root in every developed industrialized country. Policies that were suited to a paternalistic, industrialized world are no longer suited to today's health care economy. An in-depth survey asking "what women want" is certainly just as relevant today as it was in 2000 when it was conducted. The survey found that "a large majority of women - 72 percent -- would like their health insurance to be independent of their employment. This was not even one of the issues the pollsters had intended to ask about, but it came up repeatedly in the focus groups that preceded the polling."<sup>10</sup>

### **Tax policy is key**

I believe we are at a turning point in our health sector, and the outcome of the 2008 presidential election will largely determine which path we take. The question is this: Will we slide toward greater and greater government control over our health sector or

will we move toward a properly functioning private market for health insurance that gives people choice and control over their coverage?

In poll after poll, people clearly state a preference for private health insurance over government control of the health sector. If people are to have the option of viable private insurance, we need to realign the financial incentives that support that insurance. Addressing the tax treatment of health insurance is the first crucial step toward that goal.

This would allow greater portability of coverage and would minimize the risk that people would lose their health insurance when they lose their jobs. It would enable greater visibility over the cost of insurance and health care, providing an incentive for consumers to demand coverage that offers the best value. It would facilitate competition among insurers to enroll millions of new people and would give them an incentive to compete on price and benefit structures. And this would mean consumers would have many more choices than they do today to find the coverage that best suits their needs and pocketbooks. In a world in which individuals have more control over their insurance, they would gain peace of mind by having coverage that they own and that can follow them as they move from job to job and even state to state.

There will need to be new safeguards for consumers in this transformed world of health insurance, but that is the topic for another hearing. Many other 20<sup>th</sup> century health policies would need to be modernized in this process. For example, states need to do a much better job of allowing individuals more choice by inviting rather than suppressing competition in their health insurance markets. States would need to rethink whether the 1,900 coverage mandates on their collective books are helping or hindering access to affordable coverage. And state monopolies over health insurance could be broken by allowing consumers to purchase health insurance across state lines.

In the process of this transformation, we do not want to make changes so fast that it disrupts the coverage that gives millions of people the security they want and need. If tax policy were relaxed to allow portability of the tax benefits associated with health insurance, some employers would opt to cash out the value of the health insurance they are providing to their workers so they can buy coverage through other sources. I believe that most companies would continue to offer or sponsor health coverage for their workers, just as they do today. But giving people more options in how they arrange the financing of their insurance would get our health care system moving toward 21<sup>st</sup> century coverage that is more portable, more flexible, and more affordable.

### **The crucial element is choice**

With health care representing one-sixth of our economy, it will take a long time to make these changes. But a first step by government to encourage people to buy health

insurance would to create new allowances, whether through direct subsidies to individuals, refundable tax credits, tax deductions, or a combination, targeted directly to individuals to assist them in purchasing the health coverage of their choice.

We do need to focus the debate between those who believe that the answer to the problems in the health sector lies in much more government involvement through expansion of public programs, and those who believe that the free market can and does have much more potential to get health insurance costs down and provide people with greater access to coverage and more choices.

In our economy, incentives work and competition works. What we need to do is engage the power of consumers to transform our health sector to become more efficient, more responsive to consumer needs, and more affordable.

We have seen that the tax treatment of health insurance is a powerful force in how the health sector is organized. Making changes to offer more options would be a giant leap to begin to transform our health sector in a way that provides millions of people currently left out of the system with new resources to get coverage; that provides millions of people who are worried they could lose their coverage at work with the security of knowing that they can own their policies; and that provides new incentives to put patients and doctors back in charge of medical decisions.

Thank you for the opportunity to testify today, and I look forward to the opportunity to work with you to advance a more informed conversation about this very important issue.

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## ENDNOTES

<sup>1</sup> John Sheils and Randall Haught, “The Cost of Tax-Exempt Health Benefits in 2004,” *Health Aff* (Millwood), 2004 Jan-Jun; Suppl Web Exclusives: W4-106-12 at <http://content.healthaffairs.org/cgi/content/full/hlthaff.w4.106v1/DC1>.

<sup>2</sup> Office of Management and Budget, “Budget of the United States Government: Fiscal Year 2008,” February 5, 2007, at <http://www.whitehouse.gov/omb/budget/fy2008/budget.html>.

<sup>3</sup> Description is drawn from “A Vision Statement for Consumer-Driven Health Care Reform” by the Health Policy Consensus Group. <http://www.org/vision.asp>

<sup>4</sup> U.S. Census Bureau, Current Population Survey, 2007 Annual Social and Economic Supplement, Table HI01. Health Insurance Coverage Status and Type of Coverage by Selected Characteristics: 2006, All Races at [http://pubdb3.census.gov/macro/032007/health/h01\\_001.htm](http://pubdb3.census.gov/macro/032007/health/h01_001.htm).

<sup>5</sup> “Job openings and labor turnover: November 2006,” Bureau of Labor Statistics, United States Department of Labor, January 10, 2007. [http://www.bls.gov/news.release/archives/jolts\\_01102007.pdf](http://www.bls.gov/news.release/archives/jolts_01102007.pdf)

<sup>6</sup> The Kaiser Family Foundation and Health Research and Educational Trust, “Employer Health Benefits 2007 Annual Survey,” September 11, 2007, at <http://www.kff.org/insurance/7672/>.

<sup>7</sup> Hillary Clinton, “American Health Choices Plan,” September 2007, at <http://www.hillaryclinton.com/feature/healthcareplan/>.

<sup>8</sup> “Empowering Health Care Consumers Through Tax Reform,” Grace-Marie Arnett, Ed., University of Michigan Press, Ann Arbor, September 1999, at <http://www.galen.org/book.asp>.

<sup>9</sup> White House Fact Sheet, “Affordable, Accessible, And Flexible Health Coverage,” January 2007, at <http://www.whitehouse.gov/stateoftheunion/2007/initiatives/healthcare.html>.

<sup>10</sup> “In America. Focus on women,” Bob Herbert, *The New York Times*, September 28, 2000.